
FRBSF WEEKLY LETTER

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The Western Region in 1986

During 1986, the overall rate of economic growth in the Twelfth Federal Reserve District (Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington) slowed from its 1985 pace, but growth rates differed considerably among the western states. Arizona and Nevada were two of the fastest growing states in the country, while the economies of Alaska and Idaho were among the weakest in the nation.

For the District, nonagricultural wage and salary employment grew 2.4 percent between December 1985 and December 1986, almost identical to the 2.5 percent pace registered nationally. Arizona and Nevada had two of the fastest employment growth rates in the nation, at 4.2 and 4.8 percent, respectively. California, which accounts for about two-thirds of all Twelfth District employment, experienced 2.4 percent employment growth, while Hawaii, Oregon, and Washington also registered growth between 2 and 3 percent. In Utah, employment grew only 1.2 percent, and Idaho's employment fell an estimated 1.7 percent while Alaska's fell 5.1 percent.

As was true nationally, the economic forces with the most important effects on the West's performance were fairly robust consumer spending, lower interest rates, and lower oil prices. They affected the economic well-being of different parts of the District differently because of the various mixtures of industries among the western states. Thus, while forest products and residential construction activity benefited from lower interest rates during 1986, oil and energy companies suffered from the sharp drop in oil prices that occurred early in the year.

Trade and services

Consumer spending is important in determining the overall pace of western growth because trade and service activity together account for almost 50 percent of total employment in the western states. In 1986, consumer spending gave a major boost to the western economy, even though it grew more slowly than its frenetic

1985 pace. Indeed, the three major service-oriented sectors (wholesale and retail trade; services; and finance, insurance, and real estate) each registered employment growth at a pace one-and-a-half times that of total wage and salary employment. Moreover, these were the only sectors to outpace overall job growth by a significant margin. The extent to which consumer spending will continue to spur growth in 1987 is open to question. Concerns about rising consumer debt levels lead some to expect a further weakening of consumer spending growth this year.

One component of the service sector that received considerable attention last year was tourism. Last year, the reduced value of the dollar, fears of terrorism abroad, and Expo '86 in Vancouver were expected to provide a banner year for visitor industries, particularly those in the Pacific Northwest. Data on airport traffic and hotel vacancies suggest that the summer season was a prosperous one, although the season nevertheless may have been somewhat disappointing for those who relied on widely circulated forecasts that were exceptionally optimistic.

Construction

The pattern of western construction activity generally followed the national trend. Single-family homebuilding boomed during the spring and summer as interest rates fell. Building slowed a bit after the summer, but still maintained a healthy pace as interest rates stabilized late in the year. If mortgage interest rates continue at their current low levels, single-family construction activity should remain robust.

Multifamily residential construction was sluggish because many areas in the West have high vacancy rates. Now that tax reform has removed the tax advantages of building otherwise unprofitable projects, there is even less incentive to build multifamily housing. Combined, these factors should continue to dampen multifamily construction activity this year.

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Nonresidential construction activity likewise slowed during 1986. In the West, as in the nation, the markets for office space in most metropolitan areas are substantially overbuilt, with vacancy rates averaging close to 20 percent. As was true for multifamily residential construction, a significant proportion of the existing overcapacity was built by limited partnerships for tax shelter purposes. Thus, when the tax reform act substantially reduced the tax advantages of such investments, the amount of office construction dropped sharply.

Although the markets for retail and commercial space have not been hit as hard as the office market, the overall value of nonresidential construction awards issued during the first eleven months of the year in the Twelfth District during 1986 fell 1.5 percent below its 1985 level. The combined effects of overbuilding and tax reform should cause nonresidential construction activity to decline further in 1987.

Manufacturing

Manufacturing industries have been weak during the past year, although less so in the West than in the rest of the nation. Global competition in some traditional markets led workers to make wage concessions and firms to make substantial investments in more efficient plant and equipment. Despite the reduced foreign exchange value of the U.S. dollar, which was expected to improve domestic producers' positions relative to their foreign competitors, improvement in the trade balance was almost nonexistent during 1986. Not until the end of the year did the lower value of the dollar and cost reductions by domestic firms appear to bring about some improvement in export volumes.

Events in other manufacturing industries were not dominated by the dollar's value. For example, the aerospace industry boomed because of exceptionally strong demand from both the commercial aircraft sector and government defense contracts. Orders for aircraft continue strong and bode well for the commercial side of the aerospace industry, but the tight federal budget, as well as concern about the level of defense spending generally and the feasibility of the Strategic Defense Initiative ("Star Wars") in particular, may slow government contract awards in 1987. Nevertheless, even if the vol-

ume of contract awards were to drop, production in the affected firms would not slow until late 1987 or 1988 since only a fraction of the typical multi-year contract award is spent during the initial year of the award.

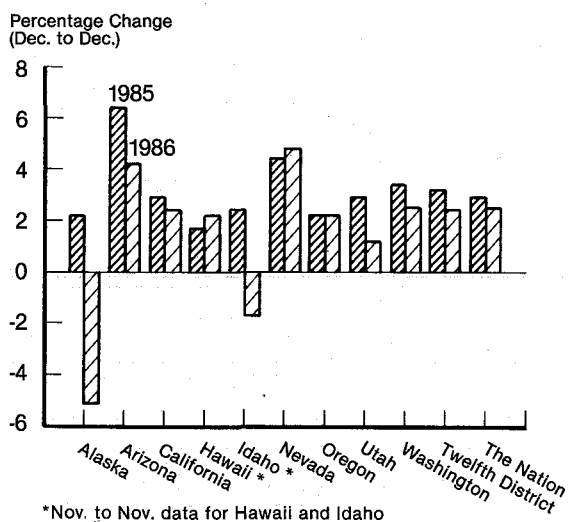
Although many observers had expected the high technology and semiconductor industries to recover from their slump during 1986, the recovery, for the most part, failed to materialize. However, recent reports of improved demand for personal computers offer some hope to semiconductor makers, and a trade ruling against Japanese semiconductor producers may make U.S. producers more competitive on world markets. These developments notwithstanding, domestic producers must continue monitoring costs and aggressively pursuing research and development possibilities if they are to regain their previous strength.

Forest products

The forest products industries are much better off now than they were last year at this time because of reductions in interest rates and the value of the U.S. dollar. Measures to cut costs and enhance efficiency implemented during the industry's five-year downslide set the stage for an upturn when, at last, economic conditions improved. In addition, although the U.S. dollar remains highly valued compared to the Canadian dollar, U.S. producers gained relative to Canadian producers because of the prolonged Canadian lumber strike and the imposition of a 15 percent export tax on Canadian lumber exported to the U.S. Due to these developments, both lumber output and exports from the Pacific Northwest grew in 1986.

Nevertheless, employment and wage levels at Northwest mills remained substantially below the levels they reached during the early 1980s, and the economies of many lumber producing areas in Oregon, Washington, and Idaho remain troubled. Given the profound changes the industry has seen during the past few years, a return to the employment levels of the late 1970s appears unlikely even under the best of circumstances. The prospects for forest products in 1987 hinge to a large extent on the levels of interest rates and the dollar, and the disposition of trade disputes with the Pacific Northwest's major competitor, Canada.

Nonagricultural Employment Growth in the West



Agriculture

Agricultural producers in the West have not escaped the adversity associated with deflation in farm prices, an increased world supply of agricultural products, and interest rates that remain high relative to inflation. Their losses have been sizable, but western farmers tended to fare better than farmers in the Midwest and about the same as the national average.

Some farmers may never recover from their problems, but producers of some western crops appear to have weathered the crisis and now face a reasonably bright future. In particular, the producers of grapes and tree nuts face a better outlook due to expanded markets (including the new wine cooler market for grapes) and improved competitiveness in world markets. In addition, the West's diverse output and flexible land use should continue to insulate western producers from the harshest blows of agricultural problems.

Energy and mining

The sharp drop in oil prices that occurred early in 1986 helped western consumers but created dramatic problems for the District's oil-producing regions. The rig count for the Twelfth District's oil-producing states (Alaska, California, and Utah) fell 45 percent between December

1985 and December 1986. This compares with a slightly larger 51 percent national decline. Mining employment, much of which is oil-related, fell 14 percent between November 1985 and November 1986 — a smaller decline than the 18 percent seen nationally. The Twelfth District's major oil-producing states, Alaska and California, registered mining employment losses of 20 and 16 percent, respectively.

While U.S. oil production fell by 5 percent between December 1985 and December 1986, oil output rose 7 percent in Alaska. Alaska's production is less responsive to short-run price changes because the high cost of oil recovery there requires firms to make long-range investment commitments.

The dramatic effects of oil-related problems in Alaska showed up in stalled construction activity and in a crisis in the state's budget because of the importance of oil money in funding both. As a result of weakness in oil, government, and construction activity, December employment in Alaska stood 5.1 percent below its year-earlier level.

California's oil industry, much of which is concentrated in Kern County, is more responsive to short-run market conditions because it consists of many small, independent oil producers. As a result, oil production fell by 9 percent in California during 1986, while Kern County mining employment fell by about a third.

Summary

During 1986, economic growth slowed in the Twelfth District as it did nationwide. Lower interest rates stimulated residential construction and forest products activities, while continued strong consumer spending in most parts of the District boosted trade and service-related activities. The sharp reduction in oil prices that occurred during the spring hurt oil-producing regions dramatically. The reduced foreign exchange value of the dollar did not help U.S. producers as much as most analysts expected in 1986, but more substantial improvement is expected during 1987. Overall, the outlook for 1987 is good, but depends to a large extent on the course of oil prices, the U.S. dollar, and interest rates.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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Nevada Oregon Utah Washington

Research Department Federal Reserve Bank of San Francisco

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/14/87	Change from 1/7/87	Change from 1/15/86 Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	206,841	— 859	3,670	1.8
Loans and Leases ^{1 6}	186,131	— 949	2,391	1.3
Commercial and Industrial	54,835	— 689	2,145	4.0
Real estate	67,099	— 94	1,028	1.5
Loans to Individuals	39,041	— 247	409	1.0
Leases	5,593	8	— 121	— 2.1
U.S. Treasury and Agency Securities ²	13,569	116	2,742	25.3
Other Securities ²	7,142	— 24	— 1,463	— 17.0
Total Deposits	209,835	— 4,988	5,589	2.7
Demand Deposits	54,799	— 4,516	3,887	7.6
Demand Deposits Adjusted ³	50,559	9,922	4,424	9.5
Other Transaction Balances ⁴	19,857	— 426	4,491	29.2
Total Non-Transaction Balances ⁶	135,179	— 46	— 2,788	— 2.0
Money Market Deposit Accounts—Total	45,955	— 1,040	41	0.0
Time Deposits in Amounts of \$100,000 or more	32,469	291	— 5,693	— 14.9
Other Liabilities for Borrowed Money ⁵	27,876	1,589	1,801	6.9
Two Week Averages of Daily Figures	Period ended 1/12/87	Period ended 12/29/86		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (—)	1	10,277		
Borrowings	3	11		
Net free reserves (+)/Net borrowed(—)	— 1	10,266		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change